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Israel: Economic Problems Facing the Shamir Government [redacted] 25X1

An Intelligence Assessment

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NESA 83-10332
December 1983

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Israel:
Economic Problems Facing the Shamir Government [redacted]

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An Intelligence Assessment

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This paper was prepared by [redacted] Office of Near Eastern and South Asian Analysis, with a contribution from [redacted] Office of Central Reference. It was coordinated with the Directorate of Operations. [redacted]

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Comments and queries are welcome and may be directed to the Chief, Arab-Israeli Division, NESA, [redacted]

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Israel: Economic Problems Facing the Shamir Government

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Key Judgments

Information available as of 22 November 1983 was used in this report.

When the Shamir government took office on 10 October, it was immediately confronted with an economic crisis stemming from the outgoing Begin government's failure to address the country's persistent economic problems. When Begin involved himself in economic policy disputes, he took the politically expedient path. The resulting consumer spending spree that began in early 1981 with the government's preelection tax cuts did not slacken. Much of the increased consumer demand was met by imports. The consequences of Begin's policies began to be felt last year as slumping exports produced the first real decline in GNP since 1953. 25X1

If the Shamir government enforces the budget cuts it has already agreed to, our analysis indicates it will be faced with rising unemployment, higher inflation, and a widening financial gap. Inflation and the financial gap would be further exacerbated if, as seems more likely, the budget cuts do not materialize. Israel must reverse the decline in its exports to prevent a further worsening of the deficit in civilian goods and services. Limiting domestic demand alone in order to reduce imports would entail a significant political cost in the form of double-digit unemployment. Even if GNP growth is significantly reduced, the financial gap in 1986 would still exceed the amount recorded last year. 25X1

Traditional fiscal and monetary policies have limited utility in Israel. Officials find it particularly difficult to pare the budget without cutting priority items, including military costs, social welfare, and politically sensitive subsidies. Monetary policies are severely restricted by the Bank of Israel's lack of control over the money supply, adding to inflation. Fiscal policies aimed at reducing demand by boosting prices or raising taxes are more than offset by the country's pervasive indexing system and labor's ability to bargain for large real wage gains. 25X1

New Finance Minister Cohen-Orgad supports budget cuts, but he has a difficult task in getting and keeping cabinet support for austerity. Only a strong government could take the political risk of breaking the vicious circle of indexation which feeds inflation and balance-of-payments problems. Former Finance Minister Aridor lost his portfolio attempting the feat. With the bickering parties that make up the coalition, the Shamir government does not have the political will to stick to an austerity program for the two to three years that would be required to make it work.

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Since Israel is unlikely to effectively tackle its balance-of-payments problems, the Shamir government will look for the easiest way out—asking the United States for more aid on better terms—which will allow the Israelis to postpone dealing with the problem. The level of US aid has, by mutual agreement, been determined by the state of Israel's economy. 25X1

Israeli officials would strongly resist any US attempt to use economic leverage to influence Israeli actions in the region. Security interests, rather than financial considerations, will determine Israel's political and military strategy. 25X1

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Israel: Economic Problems Facing the Shamir Government

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The Shamir government inherited severe economic problems when it took office on 10 October. The Tel Aviv Stock Exchange was closed, and Israelis were flocking in such large numbers to buy US dollars and other foreign currency that some banks ran out of foreign exchange. The chaos stemmed, in large part, from the Begin government's failure to address the country's persistent economic problems—high inflation, low investment, large real wage gains, sluggish productivity, and large external deficits on civilian goods and services. Prime Minister Shamir faces the formidable job of restoring public confidence while mustering support for austerity measures from a fractious coalition and the powerful Histadrut trade union. We believe his government is probably not equal to the task.

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Begin's Economic Legacy

Former Prime Minister Begin took little interest in economic issues and, for the most part, left economic decision making in the hands of his finance ministers, according to reporting from the US Embassy. In the few instances when he involved himself in economic policy disputes, he took the politically expedient path. As a result, finance ministers did not have the support from Begin that we believe was crucial to implement an effective austerity program. For example, the austerity policies announced by former Finance Minister Hurwitz in late 1979 fell apart in a few months, and inflation soared when the cabinet, with Begin's acquiescence, thwarted Hurwitz's efforts to cut government spending.

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The politically expedient economic policies followed during most of Begin's six-year rule resulted in:
- Real GNP growing at an annual rate of 2.8 percent.
- Real wages increasing at an annual rate of 7.7 percent.
- Private consumption expanding by 6 percent annually in real terms.
- An annual unemployment rate of 5.1 percent or below.

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Table 1
Israel: Foreign Debt

Million US $

	1979	1980	1981	1982
Total foreign debt [a]	15,138	16,517	18,231	20,918
Of which:				
Owed to US Government	5,336	6,485	7,389	9,420 [b]
Short term	1,820	1,760	2,328	2,945 [b]
Total debt servicing	2,071	2,686	3,181	3,803 [b]
Principal repayment [c]	839	957	1,071	1,100 [b]
Interest	1,232	1,729	2,110	2,703 [b]
Debt service ratio [d]	25.8	27.4	30.5	37.4 [b]

[a] Includes both public and private foreign debt, end of year.
[b] Estimated.
[c] Repayment of long- and medium-term loans.
[d] Debt service as a percentage of goods and services exports.

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The cost of this record was substantial. According to Israeli statistics:

- Inflation accelerated from 42 percent in 1977 to triple-digit levels in the past four years; prices rose a record 133 percent in 1980.

- The external deficit on civilian goods and services increased from $1.3 billion in 1977 to $3.2 billion last year.

- Foreign debt nearly doubled from $11.1 billion at the end of 1977 to $20.9 billion at the end of last year. Despite an increase in US aid from $1.8 billion in FY 1978 to $2.5 billion in FY 1983, excluding Sinai redeployment aid, Israel was forced to rely increasingly on commercial borrowing. Foreign banks were owed $596 million directly and another $2.8 billion that was borrowed by Israeli banks at the end of 1981, the last year for which data are available.

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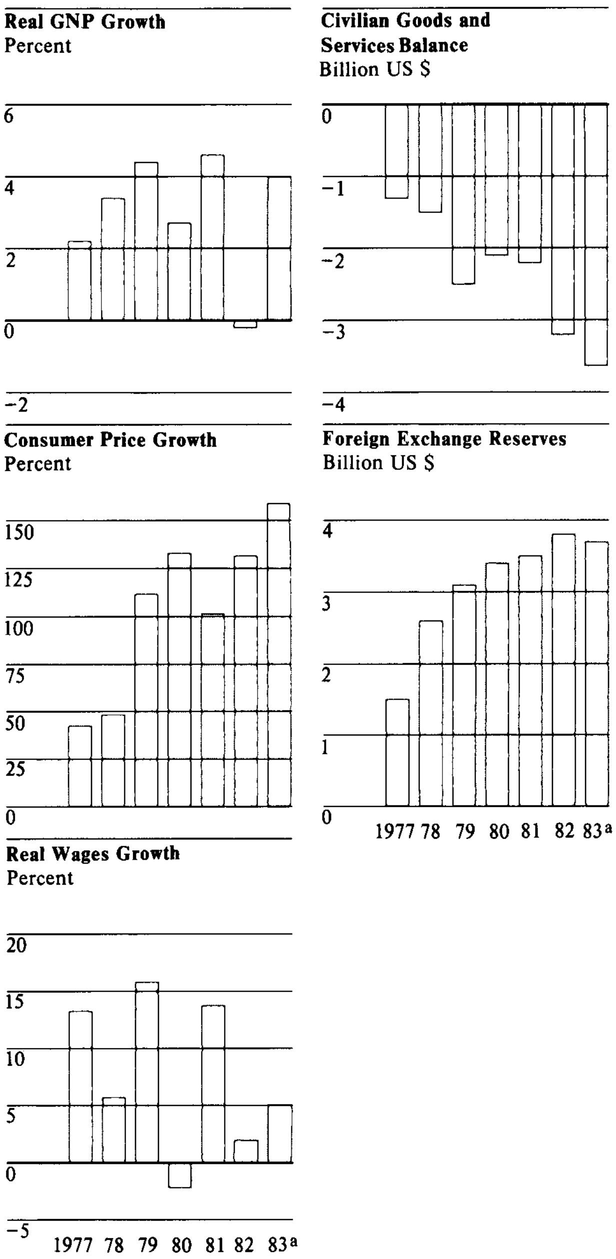
Figure 1
Israel: Economic Indicators



[a] Projected.

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Israel's Interrelated Wage Patterns

Israeli policy since the establishment of the state has been guided by a strong egalitarian ethic. So that no group of workers obtains an "unfair" salary advantage over others, Israel's wage patterns are based on a series of interrelated agreements. For example, engineers' wages are directly linked to those of teachers, and technicians' pay is linked to the engineers. A Histadrut official told an Embassy officer that he was concerned that, in the aftermath of the recent doctors' strike, disruption of traditional linkages among various wage groups could lead to chaos in the labor market. With the doctors' success in winning a 60-percent pay hike, a number of groups, including lawyers and nurses, are now trying to link their wages to those of the doctors, according to press reports. 25X1

Current Situation

The consequences of Begin's policies began to be felt last year as slumping exports produced the first real decline in GNP since 1953, according to Israeli statistics. Although recession in the West played a role in Israel's poor export performance, former Finance Minister Aridor's policy of intervening in foreign exchange markets to slow the depreciation rate of the shekel was also a major factor. Much of the 7.5-percent real increase in private consumption last year was met by imports, in part because of their lower prices in relation to domestically produced goods. 25X1

Aridor resorted to exchange rate manipulation in order to reduce the inflation rate—his goal, unrealistic, in our judgment, was to bring the rate down to 85 percent within a year. To the same end, Aridor also held price increases on government-controlled commodities to a relatively modest 5 percent a month. Last year's inflation rate of 131.5 percent narrowly missed setting a new record despite these measures. We believe that, while he was dealing with the symptoms of inflation, Aridor did little to attack its underlying causes. 25X1

Table 2
Israel: Balance of Payments

Million US $

	1979	1980	1981	1982 [a]	1983 [b]
Civilian goods and services balance	**−2,504**	**−2,121**	**−2,169**	**−3,200**	**−3,600**
Exports	8,030	9,791	10,439	10,165	10,850
Goods	4,759	5,798	5,903	5,573	5,450
Services	3,271	3,993	4,536	4,592	5,400
Imports	10,534	11,912	12,608	13,365	14,450
Goods	6,769	7,326	7,250	7,352	7,720
Services	3,765	4,586	5,358	6,013	6,730
Self-financed military imports	**250**	**250**	**−424**	**174**	**−104**
Military import payments	1,420	2,018	1,483	2,295	1,930
US military assistance	1,170	1,768	1,907	2,121	2,034
Debt repayment (medium and long term)	**839**	**957**	**1,071**	**1,100**	**1,635**
Financial gap [c]	**3,593**	**3,328**	**2,816**	**4,474**	**5,131**
Sources of financing	**4,031**	**3,616**	**2,961**	**4,817**	**5,031**
Unilateral transfers	1,400	1,474	1,584	1,422	1,530
US economic assistance	980	785	785	785	785
Israeli bonds	414	450	518	557	580
Other capital including short-term borrowing	1,186	900	137	2,009	2,136
Net direct investment	51	7	37	44	0
Change in reserves	**438**	**288**	**145**	**343**	**−100**

[a] Estimated.
[b] Projected.
[c] The financial gap is the sum of the civilian goods and services deficit, self-financed military payments, and debt repayment.

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The consumer spending spree that began in early 1981 with the government's preelection tax cuts has not slowed, according to Israeli statistics. The generous public-sector wage agreement signed late last year, combined with wage gains at the industry and plant levels, has boosted real wages during the first six months of this year to a level 7.6 percent higher than in the same period in 1982. This in turn has fueled a 10.3-percent first-quarter hike in private consumption in real terms compared with the same period last year.

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The pickup in consumer demand triggered only a moderate increase in industrial production—2.5 percent in the first half of this year compared with the same period in 1982—according to a press report. The unemployment rate in the second quarter fell to 3.9 percent compared with 4.6 percent a year earlier, according to Israeli statistics. 25X1

Much of the increased consumer demand has been met by imports—the value of consumer goods imports during the first seven months of 1983 is 23 percent higher than in the same period last year—according to Israeli statistics. As a result, imports during the first eight months have increased by $300 million—to $5.6 billion—compared with the same period last year. In addition to spurring demand for foreign consumer goods, Aridor's attempt to slow the depreciation of the shekel contributed to a drop in commodity export receipts by 4 percent during the same period because the competitiveness of Israeli goods was reduced, producing an increase in the trade deficit of $450 million. Higher interest payments on Israel's foreign debt have undoubtedly added to the services deficit.

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Tentative signs that the economy was beginning to pick up this year were not enough to stem growing public concern about the country's deteriorating foreign financial position and inflation, according to recent polls. Recent press reports claiming that Israel's credit rating in international financial markets had dropped and that foreign exchange reserves have declined spurred the public in early October to buy US dollars in anticipation of a devaluation. Many Israelis sold stocks, particularly bank stocks, for shekels to purchase dollars, precipitating a stock market crash and forcing the market's closure.

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In presenting his cabinet for Knesset (parliament) approval on 10 October, Shamir said that the government would reduce public and private consumption, cut subsidies, and raise labor productivity, and he warned Israelis that the standard of living would not improve until production is increased. The Shamir government's first act, taken after an all-night cabinet session immediately following Knesset approval of the new cabinet, was announcement of an 18.6-percent devaluation of the shekel and a 50-percent boost in the price of most government-controlled commodities, including bread and milk. These moves will undoubtedly result in a new inflation record; we believe prices will rise at least 160 percent this year. At the same time, Aridor disclosed his intention to reduce cost-of-living adjustments, thereby threatening the Israeli cushion against triple-digit inflation.

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A few days later Aridor was forced to resign after his plan to make the US dollar legal tender in Israel was reported in the Israeli press. We believe Aridor intended to use this device to circumvent the indexation system because prices would be quoted in dollars and US inflation is very low. Opposition in the cabinet centered on the limited ability Israel would have to pursue economic policies independent of the United States under such a plan. If Israel had implemented this policy, government officials could not adopt their own monetary, foreign exchange rate, or interest rate policies. Although Shamir quickly made clear that Aridor's plan would not be considered by the government, Israelis reacted to the uncertain economic climate by continuing to dump shekels.

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Although the US Embassy reported that most observers believed the reopening of the stock market on 24 October went smoothly, heavy sales of stock and purchases of foreign currency resumed on 30 October. The Israeli Government resorted to restrictions on foreign currency purchases that went into effect on 1 November. Exceptions are allowed for Israeli travelers going abroad, who can purchase up to $3,000, and importers of goods. Israeli radio reported that the black-market exchange rate was pushed to a level that exceeded the official rate by at least 9 percent as Israelis illegally purchased foreign currency outside the banking system.

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Structural Economic Problems

Lagging investment in plant and equipment and sluggish productivity are at the root of many of Israel's economic problems, limiting the potential for future growth and boosting inflation. Most financial assets, such as stocks and bonds, are linked to increases in the consumer price index. As a result, potential entrepreneurs put their funds into financial assets where they are guaranteed positive real rates of return rather than into plant and equipment investment where the payoff is by no means assured. According to Israeli statistics, plant and equipment investment has grown by less than 1 percent annually over the last decade, and its share of GNP has declined from 21 percent to 15 percent since 1973.

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Corporations were able, until last year, to take advantage of tax laws to plow profits into financial assets rather than into upgrading or expanding their plant and equipment. The Director General of the Ministry of Finance told US Government officials that this practice has hurt investment in productive assets more than any other single factor. A new law, enacted last

Prescription for a Sick Economy

Even if the Shamir government enforces the budget and subsidy cuts agreed to during Aridor's last months as Finance Minister, it will face higher inflation and a widening financial gap. (We assume that the depreciation rate of the shekel will not be slowed even if the Shamir government tried because the demand for foreign currency that would ensue would make such an effort short lived.) Using the CIA's econometric model, we project the financial gap under current policies would reach $6.4 billion in 1986 compared with $4.5 billion last year. Budget cuts alone will not dampen domestic demand enough to reduce the financial gap measurably because officials of the large trade union, the Histadrut, knowing the moral commitment of Israeli governments to provide jobs for foreign Jews taking up permanent residence in Israel and government sensitivity to unemployment, are under little pressure to moderate wage demands to protect jobs. Thus, under our baseline scenario, real wage gains boost private consumption by an average annual rate of 4 percent in 1984-86.

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These demand pressures, combined with continued budget deficits, are likely to push the inflation rate to a new record. Much of this demand will be met by higher imports, and domestic output will continue to stagnate, resulting in an unemployment rate of 9.8 percent in 1986 which, in our view, would cause severe political problems for the government.

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We doubt, therefore, that budget cuts will be implemented. Past budget cuts in Israel have not materialized because ministers have been adept at using "unanticipated" price hikes to justify their actual outlays. For example, in FY 1982, which ended on 31 March 1983, civilian expenditures rose 2.6 percent in real terms based on Finance Ministry estimates despite "cuts" approved in August 1982 to help finance the invasion of Lebanon. Should the budget cuts agreed to in the past few months not be implemented, the financial gap would reach $7.1 billion in 1986, but the unemployment rate, at 6.9 percent, would be 3 percentage points lower than in the baseline.

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It is highly unlikely that traditional sources of foreign exchange—transfer payments and Israeli bond sales—would grow enough to cover the gap. The expected increase in financial support from abroad in the wake of the invasion of Lebanon last year did not materialize. The $39 million increase in Israeli bond sales last year was more than offset by a drop in unilateral transfers of $162 million.

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We also considered a number of alternative scenarios to measure the impact of various policies on Israel's economic performance (see appendix). The results make clear that Israel must reverse the recent decline in its exports to prevent a further worsening of the civilian goods and services deficit. In a scenario where GNP growth is significantly reduced in order to cut imports, the financial gap in 1986 exceeds the level recorded last year by $1.5 billion. Limiting domestic demand alone would entail a significant price in the form of higher unemployment—reaching double-digit levels by 1986.

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A 10-percent annual increase in export volume in 1984-86 would result in a financial gap of $3.9 billion in 1986. We believe that such a large boost in exports is unlikely. At a minimum, it would require a sharp reduction in domestic demand which would be politically difficult for the Shamir government to achieve. A more modest increase in exports of 5 percent a year in real terms would result in a financial gap in 1986 only $500 million below the baseline. A combination of modest export and private consumption growth and cuts in domestic government consumption would reduce the financial gap a little but would lead to higher unemployment. Increasing investment by 10 percent annually in 1984-86 would result in lower unemployment, but the financial gap in 1986 would be $400 million higher than in the baseline.

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year, prohibits firms from deducting the interest costs of loans used to buy financial assets, but interest on loans for plant and equipment investment is still deductible. Although the new law may account for part of the 16-percent real increase in equipment investment last year, other factors were also involved. Plant investment continued to fall, declining by 3.4 percent.

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The poor investment performance has been a major factor contributing to sluggish productivity. Productivity grew less than 1 percent on average between 1972 and 1981, the last year for which data are available, far short of the government's 4- to 5-percent target. Other factors include:

- Hesitancy of Israeli employers to lay off workers for fear of being caught short when demand strengthens.
- Greater use of unskilled Arab labor.
- Very high marginal tax rates that reduce worker incentives to work overtime or for bonuses; an average income earner is in the 60-percent tax bracket.

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Even if the shekel was no longer overvalued, significant export gains are unlikely. Economic growth in Western Europe—Israel's most important market—is expected to average only 2 or 3 percent annually over the next few years. In addition, prospects for expanding Israel's more traditional exports—diamonds, citrus, and textiles, for example—are not bright for the near term. Competition from the newly industrialized countries in textiles and other light manufacturing is fierce. The entry into the European Community of Spain and Portugal, with their own citrus industries, could hurt Israel's citrus exports to its major market. Moreover, as long as domestic demand remains buoyant in Israel, manufacturers of many of Israel's export goods can increase their sales without incurring the added cost of trying to market their goods abroad.

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Limited Policy Tools

Traditional fiscal and monetary policies have limited utility in Israel. Monetary policies are severely restrained by the Bank of Israel's lack of control over the money supply. Israel's limited financial market effectively constrains the amount of government bonds that can be absorbed by the public. Officials have resorted to selective credit controls—their only means of curbing the growth of the money supply—but bankers and companies have devised ways to get around them. Persistent budget deficits have been financed by printing money, providing a boost to inflation.

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Fiscal policies aimed at reducing demand by boosting prices or raising taxes are more than offset by the country's pervasive indexing system and labor's ability to bargain for large real wage gains. In Israel, with wages, pensions, welfare payments, long-term savings, and government-issued bonds indexed to consumer prices, the impact of these policies is quickly offset by cost-of-living adjustments.

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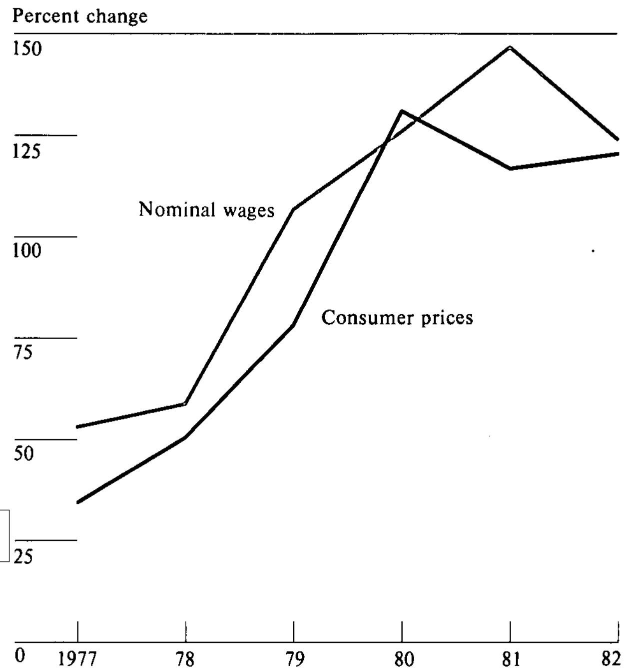
Figure 2
Israel: Wage and Price Trends



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Israel's Pervasive Indexation System

Most Israelis are insulated against the ravages of rapid price hikes because of the indexation system. As a result, the average consumer has fared well in recent years despite triple-digit inflation. Israeli politicians over the years have responded to accelerating price hikes by increasing the amount and frequency of adjustments rather than attacking the causes of inflation. As long as Israeli politicians will not tolerate unemployment levels much above 5 percent and Histadrut leaders exploit this to bargain for large real wage gains, Israel is in a vicious circle that would be politically risky to break. Aridor lost his portfolio when he attempted the feat. 25X1

Wages. *At present, wages are indexed at 80 to 90 percent of the increase in the consumer price index (CPI), depending on the inflation rate, and adjustments are made quarterly. Between 1975 and 1979 the compensation factor was 70 percent, and from October 1979 to July 1983 it was 80 percent. Cost-of-living adjustments were made annually before 1973, twice yearly from then until 1980, and quarterly since 1980. Additional bargaining at the industry and plant levels in the traditionally labor-short economy has more than made up the difference, resulting in large real wage gains.* 25X1

Other Income. *Pensions and welfare payments have been fully linked to the CPI for a number of years, and adjustments are made quarterly. This practice stems, in our view, from a widely held belief in Israel's egalitarian society that the elderly and poor should be sheltered from inflation.* 25X1

Financial Assets. *The principal on long-term savings accounts is fully linked to the CPI, and Israelis earn positive real rates of return averaging 3 percent. Government-issued bonds are indexed at either 80 percent or 100 percent and also have a real rate of return of about 3 percent.* 25X1

Mortgages. *The principal on mortgage loans was first indexed in 1980. Until then, mortgage payments were not linked. As a result, lenders demanded such large downpayments that many young couples were excluded from the mortgage market.* 25X1

Taxes. *Tax brackets are adjusted quarterly by 100 percent of the consumer price rise. Thus, Israelis can be put into a higher tax bracket only if their real earnings increase.* 25X1

There is little room to cut government spending. Defense, which currently accounts for 25 percent of the budget, has been considered sacrosanct because security is the government's first priority, and we believe the Israelis do not want to send signals to the Arabs that Israel might become vulnerable. Another 35 percent of spending is allocated to legally mandated debt servicing and cannot be cut. Thus, budget cuts would have to be concentrated in the 40 percent earmarked for social services, and such cuts run counter to the government's second priority—providing for an egalitarian society. 25X1

Unable to break the wage-price spiral via traditional fiscal and monetary tools, Aridor tried to get the Histadrut to agree to wage restraint, according to the US Embassy. His goal, according to the Embassy, was to prevent real wages from increasing and adding to inflationary pressures. Aridor first offered a 100-percent cost-of-living adjustment plus a boost equal to productivity gains if the Histadrut would give up additional wage hikes at the industry and plant levels. When that was not accepted, he tried to get Histadrut agreement to monthly wage increases at a fixed rate—Aridor talked about 5 percent. Histadrut officials—knowing how sensitive Israeli governments are to unemployment—are under little pressure to moderate wage demands and rejected Aridor's ideas. 25X1

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Policy Response

Despite public differences with Aridor over economic policy, his successor, Yigal Cohen-Orgad supports many of the measures Aridor was trying to implement before his resignation. Cohen-Orgad has publicly supported budget cuts, including subsidies, and reductions in cost-of-living adjustments. His differences with Aridor are primarily in style rather than substance. Cohen-Orgad has publicly stated that Aridor was not honest with the public when he did not state the hard facts about the economy and that Israelis would support austerity measures once the need for them was clearly presented. Unlike Aridor, Cohen-Orgad will probably not seek cuts in the defense or settlements budgets because of his close ties to Defense Minister Arens and his ideological commitment to the West Bank, according to reporting from the US Embassy. Thus, any budget cuts would have to come from social spending. 25X1

Cohen-Orgad faces a difficult task in getting and keeping cabinet support for austerity. Members of TAMI, a small party in the coalition whose constituency is low-income Israelis, can be expected to oppose cuts in social welfare spending and subsidies, according to the US Embassy, particularly if defense and settlements expenditures remain untouched. Other members of the coalition would probably oppose reductions in traditional public services, such as health care and education. 25X1

Opposition to efforts to reduce cost-of-living adjustments can be expected from the Histadrut even though Cohen-Orgad has pledged to work with the trade union. A Histadrut official recently told a US Embassy officer that, although the Histadrut is willing to discuss other issues with the government, it will not negotiate reductions in real wages or changes in the cost-of-living adjustment formula. According to reporting from the Embassy, Histadrut officials believe that the two-hour strike on 16 October by 70 percent of the labor force gives them a mandate for a forceful defense of their position. 25X1

Only a strong government, in our view, could take the political risk of breaking the vicious circle of indexation which feeds inflation and balance-of-payments problems. With the bickering parties that make up the coalition, we do not believe that the Shamir government has the political ability to stick to an austerity program for the length of time—two to three years—required to make it work. While Cohen-Orgad has been publicly espousing an austerity program that would result in a 7-percent decline in private consumption next year, we are skeptical that even the budget cuts adopted thus far will be implemented. 25X1

What public acceptance of the need for belt tightening existed before the Shamir government took office has probably been destroyed in the furor over Aridor's plan to link the Israeli economy to the US dollar. We believe Israelis, who have been scrambling to protect their assets, are looking for a period of stability and a continuation of the rising standard of living they have enjoyed in recent years. They will probably oppose any proposals that threaten the status quo, such as lower subsidies, reduced public services, or lower cost-of-living adjustments.

Rising unemployment, which would result if Cohen-Orgad can implement the austerity policies he has advocated, holds the greatest potential for causing political problems for the government, in our view. Cohen-Orgad would probably be forced to adopt expansionary policies once the unemployment rate rises above 5 percent. Although Israelis will not be happy about higher inflation, the political backlash will be minimal as long as the cost-of-living formula is not tampered with. The recent devaluation of the shekel should boost exports by about $500 million annually and curb imports somewhat, buying the government some time on the balance-of-payments front, but it was an important factor in the record inflation rate of 21.1 percent reached in October. 25X1

Implications for the United States

We believe the Shamir government is unlikely to effectively implement the austerity program required to attack Israel's balance-of-payments problems. Unless Israel manages to secure much more foreign financial backing than we believe is likely to be available from commercial lenders, the country will probably face a foreign exchange crisis within the next few years. US bankers, according to a number of recent reports, are becoming increasingly cautious about their lending to Israel. Although the level of concern varies among bankers, they appear to be worried about persistent triple-digit inflation, the growing trade deficit, and the possibility of a future debt rescheduling. Although Israel's foreign exchange reserves provide a cushion, faced with a difficult economic situation and the political pitfalls of austerity, we believe the Shamir government will look for the easiest way to deal with the problem. 25X1

Cohen-Orgad has publicly stated his desire to reduce Israel's dependence on US largess, but we believe that he is likely to ask the United States for increased aid on better terms and possibly ask for generous debt relief, or both, because such requests carry little political cost at home. Additional assistance would allow the Israelis to postpone dealing with the balance-of-payments problem. It could also provide some of the additional foreign exchange required if expansionary policies were pursued to deal with rising unemployment. In addition, US aid is cheaper than commercial borrowing. 25X1

Recent press reports indicate that Aridor's decision to ask the United States for a reduction of more than $400 million in the level of Foreign Military Sales (FMS) credits from $1.7 billion in FY 1985 in return for the entire sum being provided as a grant is being

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reconsidered. Defense Minister Arens publicly opposed Aridor's proposal, claiming that Israel's defense needs could not be met by the lower amount. Given Cohen-Orgad's close ties to Arens, we believe that Arens may be able to persuade the Finance Minister to ask for the entire $1.7 billion, with the grant portion increased beyond the $750 million in FY 1983. [redacted] 25X1

By mutual agreement, the level of US aid has always been determined by the state of Israel's economy, and the Israeli Government, in our judgment, will not want to alter the status quo. Israeli officials were very upset last year when US State Department officials publicly suggested that Congress should not approve an increase in aid at a time when the United States was trying to get Israel to negotiate a withdrawal agreement with the Lebanese Government. We believe the Israelis do not want a precedent set that would allow the United States to use economic leverage over Israel for political reasons. They would strongly resist any US attempt to use this leverage to influence Israeli actions in the region, particularly Lebanon. In any event, Israeli perceptions of their security interests rather than financial considerations will determine their military and political strategy. [redacted] 25X1

Appendix

The Israeli Econometric Model and Various Scenarios

The CIA econometric model of Israel is designed to make forecasts of Israeli economic performance. Using exogenous variables ranging from Israeli fiscal policies to OECD growth rates, the model projects various endogenous variables. These variables include:

- Measures of Israel's real domestic economic performance, including GNP, private consumption, and private investment.
- Measures of Israel's balance-of-payments position, including imports and exports and the exchange rate. [redacted]

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Using the model, we have developed several scenarios to measure the impact of Israeli policy changes. We started with a baseline scenario that assumes that the Israeli Government continues to pursue current economic policies, including the budget cuts that have been approved in recent months, and that US aid remains at present levels. We then looked at what would happen if the budget cuts were not enforced in scenario 1. [redacted]

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We also considered a number of alternative scenarios to measure the impact of various policies on Israel's economic performance. In scenarios 2 and 3 we assumed annual real growth of exports in 1984-86 of 10 percent and 5 percent, respectively. We wanted to assess the impact of a reduction in GNP growth on imports. In scenario 4 we assumed real private consumption growth of 2 percent in 1984-86, declines in government civilian consumption of 3 percent, 2 percent, and 1 percent in 1984, 1985, and 1986, respectively, and cuts in domestic military consumption of 5 percent during 1984-85 and no growth in 1986. In addition, we wanted to measure the impact of modest export growth and reduced domestic demand, so scenario 5 combines scenario 3 and scenario 4. Moreover, since poor investment performance has plagued the Israeli economy in the past decade, we ran scenario 6 in which investment growth of 10 percent during 1984-86 is assumed. [redacted] 25X1

Table 3
Israel: Alternative Economic Scenarios

	Real GNP Growth (*percent change*)			Unemployment Rate (*percent*)			Financial Gap (*billion US $*)		
	1984	1985	1986	1984	1985	1986	1984	1985	1986
Baseline scenario	−0.1	3.5	4.6	7.6	8.9	9.8	5.7	5.8	6.4
Scenario 1	6.7	5.8	3.7	6.9	6.8	6.9	5.9	6.3	7.1
Scenario 2	4.3	8.8	9.5	7.2	7.2	6.4	5.0	4.4	3.9
Scenario 3	0.7	4.6	6.2	7.5	8.6	9.0	5.5	5.5	5.9
Scenario 4	−2.2	1.4	2.0	7.8	9.7	11.3	5.6	5.6	6.0
Scenario 5	−1.4	2.4	3.4	7.8	9.4	10.6	5.5	5.2	5.2
Scenario 6	2.2	5.7	6.0	7.4	8.1	8.2	5.7	5.9	6.8

25X1 [redacted]